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SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1938

No. 98

M. E. BLATT COMPANY,
Petitioner,

vs.

THE UNITED STATES.

PETITION FOR WRIT OF CERTIORARI TO THE COURT OF CLAIMS AND BRIEF IN SUPPORT THEREOF.

Lawrence Cake,
Counsel for Petitioner.

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No. 98

M. E. BLATT COMPANY,

Petitioner,

vs.

THE UNITED STATES.

PETITION FOR CERTIORARI TO THE COURT OF CLAIMS.

The petition of M. E. Blatt Company respectfully represents:

Summary Statement.

Petitioner sued in the Court of Claims to recover the amount of an income tax deficiency assessed and paid for its fiscal and taxable year ended January 31, 1932.

The additional tax in dispute resulted from the inclusion in petitioner's gross income for the taxable year of an item of $1,742.31, determined as follows:

Shortly before the beginning of the taxable year, petitioner leased certain real estate to Ventnor Realty & Leasing Company, for a term of ten years, for a moving picture theatre. As a part of the agreement the lessor undertook

to make certain alterations and improvements, and the lessee undertook to install moving picture and talking apparatus, theatre seats, and other fixtures, furniture and equipment necessary for the operation of a theatre. The lease expressly provided that all such fixtures, furniture and equipment "shall at the expiration or other sooner determination of this lease become the property of the landlord." In accordance with the agreement of the parties, the improvements were made, at a cost of $114,468.77 of which the lessee paid $40,674.30, as set out in the findings of fact. Upon the audit of petitioner's income tax return for the taxable year in question, the Commissioner determined that the depreciated value—at the end of the term of the lease—of the improvements for which the lessee had paid $40,674.30, would be $17,423.14, and that the latter amount should be spread over the term of the lease and an aliquot part thereof, i.e. one-tenth or $1,742.31, treated as income to the lessor for each year of the term, beginning with the taxable year ended January 31, 1932.

The question presented is whether improvements so made by a lessee, as required by the lease agreement, to the property which is the subject of the lease, which improvements become the property of the lessor at the expiration or other sooner determination of the lease, constitute income to the lessor at the time of completion of the improvements to the extent of the fair market value thereof.

The Commissioner's action, and the judgment of the court below, are supported by the Commissioner's regulations. Article 63 of Regulations 77 promulgated under the Revenue Act of 1932.

The petitioner contends: 1) that the question presented is not one of statutory construction, as intimated in the opinion of the court below, but is whether a certain appreciation or accession of value to property owned by petitioner is income or gain, in a constitutional sense, at the

time it occurs; and 2) that the improvements in question made by its lessee cannot be treated as income to petitioner until the sale or other disposition of the property of which the improvements are a part, because there is no income, in a constitutional sense, until there is a realization thereof by the taxpayer, either by severance from the source or by conversion of both source and income into a different form.

On the general issue stated—the validity of the regulations which treat as income to the lessor the value of improvements made by a lessee, the Treasury has been directly sustained by the Board of Tax Appeals in

Hewitt Realty Co., 29 B. T. A. 1205;
Emma C. Morphy, 35 B. T. A. 289;
Julia Willms Sloan, 36 B. T. A. 370.

The petitioner, on the other hand, is supported by the 2nd Circuit Court of Appeals, reversing the Board of Tax Appeals, in

Hewitt Realty Co. v. *Commissioner*, 76 F. (2d) 880;

and by the district courts for the districts of Maryland, Eastern Pennsylvania, and Connecticut, in

Hilgenberg v. *United States*, 21 Fed. Supp. 453;
Staples v. *United States*, 21 Fed. Supp. 737;
English v, *Bitgood*, 21 Fed. Supp. 641.

The Court of Claims in the instant case distinguishes the *Hewitt* case on the facts, and does not mention the several district court cases cited, although District Judge Coleman in the *Hilgenberg* case and District Judge Maris in the *Staples* case both filed lengthy opinions fully discussing the question.

Examination of the opinion in the *Hewitt* case will show that although the case might have been decided on narrower ground (in that the lessee there had an option to renew the lease) in fact the decision of the court went broadly on the

ground that the lessor could not be charged with the value of the improvements—as income—prior to sale or other disposition of the property, and that the Commissioner's regulations which required such treatment were invalid.

The decision in the *Hewitt* case has become a precedent and has been expressly followed in the three district court decisions cited.

In the opinions in all the cases cited, namely,

Hewitt Realty Co. v. *Commissioner,* 76 F. (2d) 880;
Hilgenberg v. *United States,* 21 Fed. Supp. 453;
Staples v. *United States,* 21 Fed. Supp. 737;
English v. *Bitgood,* 21 Fed. Supp. 641;

the question is fully discussed and the conclusion reached that the regulations in question are invalid.

The decision of the Court of Claims in the instant case is in irreconcilable conflict.

Reasons Relied on for Allowance of Certiorari.

The case involves an important question of Federal income tax law on which there is a conflict between the Court of Claims, on the one hand, and the Second Circuit Court of Appeals and district judges in the districts of Maryland, Eastern Pennsylvania, and Connecticut, on the other hand.

Wherefore your petitioner respectfully prays that a writ of certiorari issue out of and under the seal of this Court, directed to the Court of Claims, commanding that court to certify and send to this Court for its review and determination, on a day certain to be therein named, a full and complete transcript of the record and all proceedings in the case numbered and titled on its docket, No. 43592, M. E. Blatt Company *vs.* The United States.

M. E. Blatt Company,
By Lawrence Cake,
Counsel for Petitioner.

BRIEF IN SUPPORT OF PETITION FOR CERTIORARI.

Opinion of Court Below.

The opinion of the Court of Claims is in the record at pp. 9-14.

Jurisdiction.

Certiorari is sought under Section 3 (b) of the Act of February 13, 1925, c. 229, 43 Stats. 939; U. S. Code, Title 28, Section 288.

Final judgment was entered in the Court of Claims on May 31, 1938.

Statement of Case and Outline of Argument.

The facts are sufficiently stated in the petition for certiorari.

The question presented is whether improvements made by a lessee, as required by the lease agreement, to the property which is the subject of the lease, which improvements become the property of the lessor at the expiration or other sooner determination of the lease, constitute income to the lessor at the time of completion of the improvements to the extent of the fair market value thereof.

The Treasury takes the position that such improvements constitute income to the lessor to the extent of the estimated depreciated value thereof at the termination of the lease and that an aliquot part of such estimated value is chargeable to the lessor as income for each year of the term. Article 63 of Regulations 77 under the Revenue Act of 1932.

Origin of Present Regulations.

The first regulations dealing with the question of gain derived by a lessor from the construction or addition of improvements to leased property were Regulations 33 under

the Revenue Act of 1916, based on T. D. 2442, dated February 16, 1917, to the effect that "when improvements become a part of real estate, the difference between cost of the improvements and allowable depreciation during the lease term is gain or profit to the lessor *at the end of the lease term* and is to be accounted for as income at that time."

In 1919, in *Miller* v. *Gearin*, 258 Fed. 225, this regulation was expressly disapproved by the Ninth Circuit Court of Appeals. In that case the property in question had been leased by the owner in 1907 pursuant to an agreement whereby the lessee erected a building. On the lessee's default in 1916 the owner took back the property. The Treasury taxed the owner on the increased value of his property as income realized in 1916. The court said:

> "The lessor acquired nothing in 1916 save the possession of that which for many years had been her own. The possession so acquired was not income. It was not a gain, but was a loss. Assuming that the building was income derived from the use of the property, we think it clear that the time when it was 'derived' was the time when the completed building was added to the real estate and enhanced its value. At that time it represented a prepayment to the lessor of a portion of the rental, distributable over a period of 23 years. The lease provided that the ownership of all buildings or improvements put upon the premises was to vest in the lessor immediately upon the construction of the same, subject to the provisions of the lease. * * *"

In 1920, in *Cryan* v. *Wardell*, 263 Fed. 248, the District Court for the Northern District of California held to the same effect, following *Miller* v. *Gearin*. Certiorari to review the decision in *Miller* v. *Gearin* was sought by the Treasury but was denied, 250 U. S. 667.

Thereupon the Treasury changed the regulations to provide that the gain or income to the lessor resulting from the

making of improvements by a lessee would be treated as derived by the lessor "at the time when such buildings or improvements are completed." T. D. 3062, 3 Cum. Bull. 109, and Regulations 45 (1920 edition), Article 48, under the Revenue Act of 1918.

Again, in 1922, the regulations were amended to provide for the alternative treatment whereby the estimated depreciated value of the improvements might be spread over the life of the lease and an aliquot part thereof reported as income for each year of the lease. Regulations 62, Article 48, under the Revenue Act of 1921. Since then there has been no substantial change in the regulations.

The Decision in Miller v. *Gearin.*

Miller v. *Gearin* has been assumed to be authority for the proposition that a lessor may be taxed on the value of improvements added to real estate by the lessee thereof, *as income realized by the lessor at the time the improvements are added. United States* v. *Boston & Providence R. R. Co.*, 37 F. (2d) 670; *Crane* v. *Commissioner*, 68 F. (2d) 640. See also the decisions of the Board of Tax Appeals in *Slack*, 35 B. T. A. 271; *Morphy*, 35 B. T. A. 289, and *Sloan*, 36 B. T. A. 370.

That that assumption has been a mistaken one is apparent from a consideration of the facts in that case and the opinion of the court on the narrow issue involved. In effect *Miller* v. *Gearin* has been a very misleading case. In the *Hewitt* case, the *Hilgenberg* case and the *Staples* case, cited heretofore, the opinions particularly discuss and point out the misconception by the Treasury and the Board of Tax Appeals of the decision in *Miller* v. *Gearin*. On this point in the *Hilgenberg* case the court said:

> "The theory underlying the present attitude of the Commissioner and all of the decisions of the Board of Tax Appeals appears to be founded on the misconcep-

tion that since the value of the improvements is not income at the time the lease is terminated, it must of necessity be income when they are completed. This, of course, is a *non-sequitur*, because it need not be income at either time. * * * In so far as the decision in the *Miller* case, or in any other case referred to, is to be considered as a holding to this effect, we must disagree with such holding, because we believe that the conclusion and reasoning upon which such conclusion is based, in the *Hewitt Realty Company* case, *supra*, are more sound."

It may be noted also that in the *Morphy* case, 35 B. T. A. 289, three members of the Board dissented, as follows:

"ARUNDELL, *dissenting:*

It seems to me that the decision of the Second Circuit in the *Hewitt Realty* case, 76 F. (2d) 880, gives a sound solution to the question here involved. The substance of the holding in that case is that the erection of a building by a lessee does not result in realization of income to the lessor; the realization of income, if any, occurs when the lessor sells. This view, as stated by Judge Learned Hand, author of the majority opinion, 'answers every fiscal necessity far more directly and simply than any other formula.'

"The lease in the instant case was for a period of over thirty years. Under the view expressed in the Commissioner's regulations and approved by the majority opinion, it is necessary to look into the future to the time when the lease terminates and determine the value of the building after taking into account the ravages of time. In many cases of long-term leases the original term extends beyond the useful life of the improvements. Some of them involve definite provisions for renewal. There are always the possibilities of termination prior to the expiration of the agreed term, and accelerated depreciation and obsolescence resulting from causes unforeseeable when the lease is executed. These are factors that complicate any attempted appli-

cation of the Commissioner's regulations. But what is more serious they show the impossibility of determining with any fair certainty the amount to be treated under the regulations as realized income. A promise to turn over possession of a building many years hence, and subject to the many contingencies necessarily involved in any transaction extending over a period of years, does not seem to be in any proper sense the present equivalent of cash. Cf. *Burnet* v. *Logan*, 283 U. S. 404. The difficulty of determining as a matter of fact the value of improvements is recognized in both opinions filed in the *Hewitt* case. The majority opinion obviates the difficulty and offers a sound solution. It treats as income the full amount eventually realized when it is actually realized. Anything short of this does not meet the test of realized income with which the taxing act is concerned. For these reasons, I think we should adopt the principle of the *Hewitt Realty* case and decline to follow the earlier cases that hold otherwise.

"Sternhagen and Tyson agree with this dissent."

The Lease in the Instant Case Expressly Stipulated That the Improvements Added by the Lessee Would Become the Property of the Lessor at the Expiration or Sooner Determination of the Lease.

This is expressly found in paragraph 3 of the special findings of fact, R. 6-8.

Yet the court below states in its opinion, as its conclusion on the principal issue, that "improvements to leased property made by a lessee, which become the property of the lessor at the time made, constitute compensation paid by the lessee as additional rental for the use of the leased premises."

The Improvements Made by the Lessee in the Instant Case Cannot Rightly Be Treated as Income to Petitioner Because There Was No Realization in the Taxable Year of Taxable Gain.

This is the fundamental question involved in the case. Petitioner submits, with respect for the decision of the court below, that the improvements in the instant case cannot be treated as income for the taxable year in question, unless the rule heretofore established by *Eisner* v. *Macomber*, 252 U. S. 189, and other cases, that to constitute taxable gain or income, in a constitutional sense, there must be a realization, either by severance from the source or by conversion of both source and gain into a different form, is to be disregarded or overruled.

It is to be noted that the improvements in the instant case, made by the tenant, were that part of the ventilating system charged to the tenant, glazing, architect's fee and other items, chairs, draperies, electric signs and marquee, all of which were the fixtures, furniture and equipment necessary for the operation of a theatre which the tenant agreed to install, and which, it was agreed, would become the property of the landlord at the expiration or other sooner determination of the lease.

It is difficult to understand how it can be contended, with any sense of reality, that the landlord realized any income upon the making of these improvements or at any time during the taxable year in question. The practical difficulty in the situation becomes more apparent, moreover, when consideration is given to the fact that the taxpayer must pay the tax on this income for each year of the lease, from 1932 to 1940, and to the provisions of recent and existing revenue acts, applicable for the years 1936 and 1937 and to some extent for 1938, which impose penalty taxes on the undis-

tributed income of corporations. It is a fair question to ask how the taxpayer in the instant case is to distribute this so-called income, chargeable to it for each taxable year from 1932 to 1940, so as to avoid the penalty taxes on undistributed income?

Respectfully submitted,

LAWRENCE CAKE,
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